THE FINANCIAL INDUSTRY: TWO DECADES OF CHANGE

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by

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INTRODUCTION AND OVERVIEW

In 1972, E.P. Neufeld's The Financial System in Canada[1] was published. While this remains the definitive history of Canadian financial institutions the industry has undergone rapid transition in subsequent years. The purpose of this paper is to document that change and to provide a structural description of Canada's contemporary financial system.

This paper covers roughly the period between 1970 and the present. But, naturally, developments during these years were heavily influenced by what had happened before -- particularly the revision of the Bank Act in 1967 and its relevant implications are of course discussed here. During the period under study, the Bank Act underwent another complete revision in 1980, and this is also discussed in detail.

The most important developments in recent years have been the emergence of global financial markets, allowing for increasingly large capital flows across national borders; and, the erosion of the legislative and functional separations between the so-called "four pillars" of the financial industry (the chartered banks, trust companies, life insurance companies, and investment dealers). Both of these trends have heavily influenced the Canadian capital markets. Many of the topics in this paper are directly linked to at least one of these major trends. Among the developments that have re-shaped Canadian financial institutions are: the increased competition among different types of financial institutions; increased concentration in the ownership of non-bank financial institutions; the entry of foreign banks; the incorporation of new domestic banks; the increased intrusion of the computer into the provision of banking services; and the introduction of deposit insurance.

As the accompanying table indicates the chartered banks remained the dominant financial institution -- as they have been throughout Canadian history. At the end of 1970, their assets totalled some $33.7 billion. In contrast, trust companies had only $6.5 billion, credit unions $5.1 billion; mortgage companies $3.1 billion; and, investment dealers $1.7 billion. At the end of 1983, the chartered banks still held the large majority of financial assets. But it is virtually impossible to make comparisons between their growth in relation to other financial institutions during the intervening years. Changes in the 1980 Bank Act required them, for the first time, to report financial data on a consolidated basis. Comparing banking statistics from before and after the legislation came into effect is therefore meaningless.

Throughout the period under study, the assets of all types of financial intermediaries grew at a much faster rate than the Gross National Product (GNP). This is a continuation of a trend that started in the early 1950's. There were similar periods of rapid growth in the assets of financial institutions between 1870 and 1910, and in the 1920's. Over long periods the stock of the assets of financial intermediaries grew about one percent faster than current GNP.[2] This makes the growth in recent years well above the historical average.

Distribution of Financial Assets

(In $ billion)

	1983	1977	1970
Chartered Banks	386.6	141.5	33.7
Life Insurance Companies	70.7	34.5	N/A
Trust Companies	52.6	23.2	6.5
Local and Central Credit Unions	45.9	23.8	5.1
Mortgages Companies	39.4	9.4	3.7
Property and Casualty Insurance Companies	16.9	8.3	3.1
Finance Companies	12.8	11.9	N/A
Investment Dealers	8.6	5.2	1.7
Other	27.9		

Source: Financial Institutions Statistics Canada - Catalogue No. 61-006.

RETAIL BANKING

It is generally perceived that until relatively recently, the lines between the different types of financial institutions were clearly drawn, and that companies within each of the "four pillars" did not compete with each other. The fallacy of this impression is revealed in this quotation from the 1964 report of the Porter Commission:

> In the course of the growth and development of the last three decades, and particularly since the end of the war, the financial institutions and markets have become much more flexible and competitive. While there are still traces of a reluctance to change, and of an exaggerated reliance on prestige in some institutions, it is generally true that the opportunities for undertaking profitable new lines of business and the sweeping changes in the financial environment both at home and abroad have caused undue conservatism and a lack of imagination to give way to a more adventurous and innovating spirit. Thus, the older institutions have undergone pronounced changes in their character and attitudes and moved into new lines of business, while on all sides a greater willingness to compete by price and other measures has accompanied the growth of more vigorous and varied intermediaries and markets. In this changed environment, a failure to compete is much more likely to result in a loss of position to the institutions concerned than it is to produce fundamental damage to the economy as a whole, since the traditional division of the financial business into semi-private preserves has been replaced by a more open system in which virtually no one feels bound to stay in the field where he first got his start, and almost everyone is subject to competition from both newcommers and established institutions."[3]

Deposits

On the liabilities side of their balance sheets, some institutions did offer fixed term certificates, but they were in denominations that were too large to make them affordable to the average consumer. Most members of the public have always held chartered bank

deposits. But because of the low rates of interest paid on these deposits, they were generally looked upon as means of storing cash and as easy ways of making payments rather than investments.

Until the late 1950's the chartered banks offered only one type of consumer deposit, the so-called "ordinary or regular savings account". Due to the increased use of cheques for the transfer of funds, the banks introduced chequing accounts in 1957. These differed from regular savings accounts because no interest was paid, and cleared cheques were returned to the account-holder along with a monthly statement.

During the 1960's American banks started to compete actively for household savings in the United States by offering different deposit instruments. Canadian counterparts were prevented from following this innovation by legal restrictions which prohibited the banks from charging more than six percent interest on loans. Obviously, any financial institution cannot make a profit if they pay their depositors more than they can charge on their loans. But by this time, market forces had driven up the rates that had to be paid to depositors.

The interest rate ceiling was removed in the 1967 revision of the Bank Act. At the same time, the level of required cash reserves on notice deposits was lowered to four percent. Both of these legislative changes had the effect of making it profitable for the banks for the first time to offer accounts that paid a high rate of interest. In May 1967, all of the banks introduced true savings accounts. There were no chequing privileges associated with these accounts, and, when they were introduced, depositors earned a rate that was 150 basis points above that paid on ordinary savings accounts. Many of the trust companies quickly followed the chartered banks and introduced their own special non-chequeable savings accounts, and paid the same premium interest rate.

From these modest beginnings, deposit-taking institutions actively tried to attract the savings of individuals by introducing a variety of different deposit instruments. For instance, in 1973, all of the chartered banks began to offer "package accounts" modelled after a service provided by the Wells Fargo Bank in San Francisco. While the exact services provided to customers varied from bank to bank, there were a great number of features that the most of the "package accounts" had in common. Usually included were an identification card, personalized chequing, unlimited free chequing, no required minimum balance, free money orders, travellers cheques, and safety deposit boxes, as well as reduced interest on loans.

Along with offering different types of deposits, financial institutions have developed other instruments to attract household savings. In June 1959, the Canada Trust Company became the first financial institution to sponsor the establishment of a mutual fund. The Montreal Trust followed in 1961, and by the beginning of the next decade, all of the large trust companies were associated with a fund. For instance, in 1967 The Royal Trust introduced three funds -- "A" (American stocks); "B" (bonds); and "C" (Canadian stocks). In 1969, the company added an "M" fund, the proceeds of which were invested in first mortgages. In 1964, the Toronto-Dominion Bank acquired an interest in Corporate Investors (Marketing) Limited, and this mutual fund's shares were made available through the bank's branches. In the next couple of years some of the other banks followed suit, but by the late sixties, the initial enthusiasm for mutual funds had been dampened by the poor performance of the stock market.

In a complete 1972 overhaul of Canada's taxation system, the federal government substantially increased the maximum contribution that individuals could make to Registered Retirement Savings Plans (RRSP's). Some depository institutions modified or expanded existing funds to compete in the RRSP market. Other institutions, including a number of

the large banks introduced their own plans. The Bank of Nova Scotia was the first bank, soon to be followed by the others to introduce a variable rate registered retirement deposit plan. In such a scheme, the investor directly "owns" the money deposited in his name. On the other hand, an investment in the shares of a conventional fund, makes the investor a participant in a large portfolio, which in turn, holds securities. Trust companies and other financial institutions offer RRSP instruments that are similar to those of banks. In 1974, federal legislation provided the public with another opportunity to shelter income through Registered Home Ownership Savings Plans (RHOSP's). Deposit-taking institutions competed actively for these funds, soon after RHOSP's were introduced. In fact, the competition began even before the enabling legislation was given Royal Assent. Some of the trust companies accepted special deposits earmarked for later registration, and plans offered to the public were introduced at rates above those which they intended to pay over the long-run. Some of the chartered banks offered RHOSP's before they were approved by the Department of National Revenue. One of the main reasons for the aggressive competition for contributions was the provision in the legislation that allowed individuals to purchase only one plan during their lifetime, and therefore once an institution had secured a RHOSP, it could not be transferred to a competing intermediary.[5] Financial institutions still compete aggressively for RRSP and RHOSP contributions.

The process of developing many of the new services for individuals was made possible by the introduction of the computer into the provision of financial services. Thus, in the late 1970's consumers were given the opportunity to make deposits and withdrawals from accounts even when away from the branch of the institution with which they did business. The computer also simplified record-keeping which made it possible for institutions to provide a customer with consolidated statements of all financial transactions.

According to Binhammer and Williams,[6] financial institutions have deliberately offered a wide range of services in order to attract as many customers as possible. The managers hope that at least one of these services will interest a potential customer, and once the consumer has made contract with the financial institutions, he hopefully can be persuaded to purchase other services from it.

Consumer Access

Although this kind of innovation is a good indicator of the increased competition for consumer business, there are others. Financial institutions, for instance, have made a concerted effort to make financial institutions more accessible to the general public. The growth in the number of bank branches provides an indication of this. In 1960, there were 5,051 bank branches in Canada. By 1980, the number of branches has grown to 7,439 in 1979. Since then, it should be said, the banks have been closing more branches than they have been opening, largely in an effort to control costs. Other financial institutions have increased the number of their retail outlets.

But this is not the only indicator of the financial institutions' efforts to make their businesses more accessible to the public. Before the 1960's, the branches of most banks and other financial institutions were located in close proximity to business and commercial establishments. As the Canadian population spread into the suburbs, the financial institutions moved with them. Today, almost every shopping mall and plaza has an outlet for at least one deposit-taking institutions. And the times when they are open for business is no longer confined to traditional banking hours -- with many of them open for business in the evenings or on weekends. The banks, in particular, have established branches to serve particular social groups. In 1969, the Provincial Bank established an Italian-speaking branch in Toronto and today all of the banks have Chinese-speaking branches in the city's

Chinatown. In 1973, the Royal Bank opened its first "community branch" in Montreal. These branches, which are usually located in low-income neighbourhoods, are only opened after meetings with members of the community, where joint decisions are reached on such things as: branch location; business hours; and, the types of deposits and other services to be offered. In addition to their regular banking duties, the personnel at these branches are expected to perform an educational and counselling roles.

Automated Tellers

Automated teller machines (ATM's) have also increased the public's access to financial services. According to the Canadian Banker's Association, there were 1,230 automated teller machines in 1984. In just the last year, the number of ATM's grew to 1,819. Clearly, the rapid installation of ATM's has largely been motivated by cost-saving considerations. The retail business, with its high overheads, is the most costly phase of any financial institution's operations. At the same time, the ATM's have undoubtedly enabled many consumers to use financial services outside of regular business hours, and because of this, financial institutions view ATM's as an important marketing tool.

Up until now, in Canada only the five large chartered banks have been able to offer their customers an automated teller network. The limiting factor has been cost. The cost of installing one ATM is estimated to be between $40,000 and $50,000. By pooling their resources, smaller financial institutions are establishing joint ATM networks. Pacific Network Services is now providing ATM's to some British Columbia credit unions. A Toronto company, Express Network Inc. has made a deal to place machines in 300 Canadian Seven-Eleven Food stores. The Hudson's Bay Company has announced plans to install its own machines in its retail outlets, and Montreal's Provigo Food chain is believed to have similar plans.

Access Banking Inc. is the only company, other than the "Big Five" to have installed ATM's in Canada. Access has six of its Magicbanc machines in Toronto. Some of them are located in stand-alone kiosks at busy intersections, while others are in Shoppers' Drug Mart stores. All but two are open to the public on an around-the-clock basis. Access has only signed up one client so far, Guaranty Trust Co. of Toronto. But the trust's president is optimistic about getting more financial institutions to use because competitive pressures and the high cost of setting up their own ATM's will force the smaller intermediaries to join networks. By early 1985, Access will install four more ATM's in Toronto, and eventually the firm plans to establish a nation-wide network, with ATM's located in such public locations as shopping malls, subway stations, gas stations, and grocery stores. Of course, this represents a significant departure from the current practice of having most Automatic Teller Machines adjacent to financial institutions themselves.[7]

For their part, the "Big Five" chartered banks are renting out their own ATM's for use by some of the smaller financial institutions. In the summer of 1984, the Bank of Nova Scotia and the National Bank of Canada announced that they would be sharing their Automatic facilities. The Bank of Montreal intends to join an ATM network, Cirrus System Inc., that will serve customers throughout North America. Individuals will be able to use either their bank cards or their Mastercard in any of the machines. The Canadian Cirrus ATM's will carry the same logo as their counterparts in the United States. A customer visiting one country will receive money in the currency of that country, but the account will be debited in the customer's domestic currency. The machines will automatically calculate the exchange rate between the Canadian and U.S. dollars.

The Bank of Montreal will be the only Canadian principal member of the Cirrus network and has the right to sell access to the

system to other financial institutions. In this capacity, the bank will conceivably offer its own machines to other institutions joining the network. Whether the smaller financial institutions pool their own resources to establish their own ATM networks, or join ones established by the large banks, it is clear that smaller institutions will have the opportunity to offer automated services to their customers, and this, in turn, increase the competition for consumer deposits.

Marketing

The importance that financial institutions attach to capturing the savings of individuals also can be guaged from changes in their marketing strategies. According to Binhammer and Williams, financial institutions did virtually no marketing before the mid-1960's. It was not really until the 1967 Bank Act revisions that public relations and marketing departments were established. The importance that financial institutions placed on marketing can be seen in the major departures in personnel policies that were involved in the staffing of these new departments. Previously, financial institutions had placed emphasis on internal recruitment. To fill positions in their marketing and public relations departments, executives with experience in marketing were recruited from outside the industry.

In this same regard it is interesting to note the increased use that financial institutions have made of advertising. For instance, before 1967 the chartered banks had mutually agreed not to use radio and television advertising. But the competition for deposits had become so intense, that in 1976, the Canadian Bankers' Association was not able to get its members to agree on an advertising code, although six of the ten banks in existance at that time did come close to arriving at a consensus among themselves with regard to general advertising practices. The first advertising campaign consisted mainly of in-branch promotions. This progressed to advertising in daily newspaper, the electronic media,

and national magazines. As the marketers became more sophisticated, regional campaigns and campaigns directed at specific and identifiable segments of the public became more prevalent.

There are many factors that are responsible for this significant increase in the competition for consumer deposits. The three decades immediately following World War II saw large increases in personal disposable income, and this meant that the pool of funds available to financial institutions was much greater. And, the lowering of reserve requirements, made it profitable for the chartered banks to compete for deposits by raising interest rates. Rising interest rates in turn, along with high inflation, has made consumers more sophisticated and intent on seeking a higher return on the savings that they place with financial institutions.

Loans

Looking at consumer loans, one observes this same trend towards increased competition among different kinds of financial institutions was much greater. Before 1958, the chartered banks engaged in consumer loans reluctantly. The Federal Government over preceeding years did, through various guaranteed loan plans, try to encourage the banks to make loans to specific groups of individuals (examples of such plans include: Farm Improvement Loans; Home Improvement Loans; Fisheries Improvement Loans; Small Business Loans; and Canada Student Loans). Although the banks made personal loans, other than under these plans, such loans were only available to the best customers who could provide substantial collateral. Although The Bank of Commerce had set up a small loans department as early as 1936, its lending policies did not differ substantially from those of other banks.

This left the field of consumer lending pretty well in the domain of the credit unions, which in fact were created precisely to

provide this service to their members. Originally they strove to provide loans at below market rates. They were able to do so because members were willing to accept a lower return on their deposits, in the knowledge that they had access to credit. The credit unions' ability to offer low-cost loans was substantially reduced, by the necessity for them to offer savings instruments that competed with Canada Savings Bonds, and those of other financial instruments.

The Bank of Nova Scotia was the first bank to move aggressively into consumer lending, with the introduction of its "Scotia Plan Loans" in 1958. By 1963, all of the other banks had followed Scotia's lead. At first, lending policies were very conservative. Initially, the banks only lent money to consumers for the purpose of purchasing automobiles or household durables which could be pledged as security. As they gained experience in lending, they started to make loans for a greater variety of reasons. When assessing loan applications, they began to base their decision more heavily on the applicant's potential income or "cash flow" rather than the value of the borrower's assets. The willingness of lenders to use these criteria was no doubt heavily influenced by the availability of more liberal unemployment insurance and welfare benefits.

The banks' sudden interest in consumer lending can be explained in a number of ways. Binhammer and Williams suggest that in part this was a defensive strategy. With the development of the markets in short-term commercial paper, there was more competition for commercial lending, the most important source of the banks' loan business. Consumer loans provided new source of revenue that compensated for the loss of commercial business. Of course, another important factor was the removal of the 6% ceiling on bank loans. This allowed banks to take extra compensation for the added risk of making unsecured loans to individuals. Also a significant factor in the entry of banks was a shift in public attitudes. Before the 1960's, consumer lending was

generally frowned upon and thrift was encouraged. Initially, the public sentiment against consumer credit was so strong, that the banks had programs in personal money management which provided information which hopefully prevent individuals from going into debt.

Mortagages

Banks had first been given the authority to make NHA mortgage loans in the 1954 revision of the Bank Act. But the banks avoided making such loans until after 1967, when the banks were enabled to issue their own debentures. But these debentures had to have a stated term of at least five years during which time they were not callable. In 1969, five-year renewable mortgages amortized over more than 25 years were permitted under the National Housing Act, allowing the lender to seek adjustment in the interest rate every five years. This made it possible for these lenders to match their mortgage portfolios with the debentures used to finance them.

The banks do some of their mortgage lending through wholly-owned mortgages subsidiaries. This is done to circumvent the provisions in the Bank Act which require that banks hold reserves against the term deposits through which they fund their mortgage portfolios. Other financial institutions do not have to keep such reserves. By setting up these subsidiaries, which are incorporated under the Loan Companies Act, the banks can get around reserve requirements, and, offer consumers mortgages at competitive rates. Before the 1980 revision of the Bank Act, the banks did not wholly own their mortgage subsidiaries. But since 1980, the large banks have all either established or gained full control of these corporations.

Since the banks entered the mortgage lending market, the trust companies have lost their dominant position. Banks now account for 32.6% of the residential mortgage market. The trust companies have

only a slightly smaller share of the market, 30.6%. However, a decade ago, the banks only had 22% of the market, while the trust companies held 37%. The banks continue to increase their mortgage business at a faster rate than trust companies. In 1983, the banks increased their mortgage portfolios by $3 billion while trust company portfolios rose by only $2.2 billion. The total mortgage market has reached $100 billion. Life insurance companies at the beginning of the 1970's made the decision to expand their real estate holdings, at the expense of their mortgage portfolios. Credit unions have taken up this segment of the market. But two life insurance companies, the London Life Insurance Co., and the Mutual Life Insurance Co. still remain active in the market.

Currently, mortgages make up about 50% of trust company assets, and 20% of bank assets. Bankers are aggressively moving into the mortgage market because of the slowdown in commercial lending, and because they offer the opportunity of offering homeowners other services, such as consumer loans and savings accounts.[8]

RESIDENTIAL MORTGAGE HOLDINGS OF MAJOR INSTITUTIONAL LENDERS

	Outstanding in $ billion June 1984	Percentage Distribution Dec. 1973	Dec. 1979	June 1984
Trust and Mortgage Loan Companies (excluding bank mortgage subsidiaries)	31.3	36.8	32.2	30.5
Chartered Banks (including mortgage subsidiaries)	34.3	22.0	29.2	33.2
Credit Unions and Caisses Populaires	15.7	11.2	14.8	15.3
Life Insurance Companies	10.5	16.8	10.2	10.2
Pension Funds	7.8	7.5	8.2	7.6
Investment Funds	1.2	1.3	1.8	1.2
Sales Finance and Consumer Loan Companies	0.7	1.8	1.3	0.7
Real Estate Investment Trusts	0.1	0.7	0.8	0.1
Other Institutions	1.2	1.8	1.6	1.2
Total	102.9	100.0	100.0	100.0

Source: Bank of Canada Review, October 1984.

OWNERSHIP AND DIVERSIFICATION

The questions of who should own a financial institution and what types of business they should be allowed to engage in are closely related. Both raise issues of conflict of interest and the efficient allocation of capital.

Much of the concern over the erosion of the barriers between Canadian financial institutions stems from developments in the United States. In this section, those developments are reviewed. Although mention is made of legislative changes in the United States, the primary emphasis is on the behaviour and performance of firms in the industry. The section concludes with a description of parallel developments in Canada.

United States

The financial system in the United States is even more fragmented than in Canada. Commercial banks can receive either federal or state bank charters. There is great variance in the banking regulations between the different states. Moreover, banks have the option of either belonging or not belonging to the Federal Reserve System. Savings and Loan Associations also can choose to be incorporated by either the federal government or one of the states. Securities dealers and investment bankers are regulated by the Securities and Exchange Commission, a federal agency.

In contrast to the complex set of American regulations that govern deposit-taking institutions, the insurance companies face a much less elaborate regulatory framework, because the industry functions with less public attention. Insurance companies are viewed as being rather stable, with little risk of market failure. They are also not seen as playing a central role in the economy. Thus, there is virtually no regulation at the federal level. State regulations, on the other hand, contain such items as types of investments that insurance companies are allowed to make, the holding of reserves to ensure solvency, and the specification of prices and rates of return.

Inter-State Banking

In 1927, the McFadden Act was passed which prohibited banks from operating in more than one state. A loophole in the legislation, made it possible for banks, through the establishment of bank holding companies, to acquire other banks outside their home states. This loophole was closed with the passage in 1956 of the Bank Holding Company Act. This law gave the Federal Reserve Board the authority to approve or disapprove requests to engage in activities which traditionally were not considered to be part of banking. The original version of this legislation contained some loopholes of its own, which were closed with amendments in 1970. One of these loopholes was that the law had originally been worded to apply only to multibank holding companies. Holding companies with only one subsidiary bank were thus left unregulated. This, among other freedoms, made it possible for nonbanking firms to acquire banks. Since 1970, the Federal Reserve Board has maintained separate lists of the activities that are and are not permissible to bank holding companies. Permissible activities include: mortgage banking, leasing, financial advisory services, credit cards, and data processing.

Notwithstanding these restrictions, the barriers to interstate banking have been crumbling in the 1980's, in part because state governments have moved more quickly than the federal government in liberalizing laws governing financial institutions. For example, in 1980, South Dakota passed legislation which allowed out-of-state banks to move their credit card operations to the state. Citibank established a subsidiary in Sioux Falls to handle its credit card operations. In March 1983, South Dakota passed another bill which makes it permissible for out-of-state bank holding companies to acquire state banks, which, in turn, may own insurance companies.

Delaware has passed an out-of-state banking bill which opened the state to major money-centre banks (banks from the cities that are major financial centres. Since the passage of the legislation, thirteen out-of-state banks have established operations in Delaware. Undoubtedly, this is at least partially the result of the state's aggressive efforts to attract banks. These include the removal of restrictive usury ceilings, and other changes in legislation that governs the relationship between borrowers and lenders. New York State has amended its banking law to allow out-of-state bank holding companies to acquire New York banks, provided that New York banks are granted reciprocal rights in the states of origins of the bank holding companies. The Massachusetts legislature has passed an interstate banking bill which allows banks from the other New England states to establish branches in Massachusetts, provided that its banks receive equal treatment in the home states of the banks that are let in.

Glass-Steagall

The Banking Act of 1933 (also known as the Glass-Steagall Act) was clearly a product of the excesses of the Crash of 1929 which saw many bank failures in the United States. An apparently impenetrable wall was set up between the securities industry and banking. Brokerage firms were not allowed to accept deposits from the public, and banks were prohibited from underwriting corporate securities. What had earlier been one industry was split into two. Even some firms were split up. For instance, the business of the powerful Morgan family was separated into Morgan Stanley and Morgan Guaranty Trust.

As with the breaking down of the barriers against inter-state banking, the main legislative impetus to breach the Glass-Steagall walls came from the states. In 1983, Business Week reported that, prodded by large out-of-state banks, at least a dozen states were considering legislation that would give state-chartered banks -even

those whose parents were not located in the particular state- the right to engage in a wide range of activities including the underwriting of securities and the selling of insurance.[9]

It is easier for some banks to get into the brokerage industry than others. A state-chartered bank that is not a member of the Federal Reserve System would be able to offer full brokerage services. The only federal regulator that would have jurisdiction would be the Federal Deposit Insurance Corp., which has already given its approval of such arrangements. If, alternatively, the bank is owned by an out-of-state holding company, or it was federally chartered, approval of the Federal Reserve Board would be needed. This can be a very long process. One year elapsed from the time Bank of America announced its intention to buy Charles A. Schwab, a discount broker, until the merger was approved by the Federal Reserve Board.

Although Glass-Steagall prohibits banks from underwriting and distributing corporate securities, they are permitted to purchase and sell securities for their customers. They had done so for years before their large-scale move into the brokerage industry, but volumes had been modest. The move by banks into discount brokerages, which execute trades in securities for customers, without providing either fiduciary services or investment counselling, was merely an extension of their existing business. (The emergence of these discount brokerage firms is a direct consequence of the elimination of fixed commission rates in the securities industry which became effective on May 1, 1975.)

The first bank to enter the discount brokerage business was the Los Angeles-based Security Pacific Corp. It started by having Fidelity Brokerage Services execute its customers' trades. In January 1983, the company purchased its own discount broker, Kahn & Co. of Memphis. The Bank of America entered this field at an early stage with its purchase of Charles Schwab. In its 1983 article, Business Week

claimed that there were 600 banks and savings and loan associations that had either entered or were planning to enter the discount brokerage business.

While much of the controversy over bank challenges to Glass-Steagall has focused on their move into discount brokerages, the largest expansion will probably take place in investment banking. Already, the large American banks are providing a full range of financial services to their corporate clients overseas, and they want to apply this experience to their domestic customers.

American banks have always been able to underwrite most of the securities issued by municipalities, and they have moved aggresively into this field. A few companies, led by J.P. Morgan & Co., the parent of Morgan Guaranty have broken new ground by entering the futures market. These banks are now trading financial futures contracts for corporations interested in hedging futures contracts. The large banks are also heavily involved in the market for U.S. Government securities.

The Glass-Steagall Act's prohibition of underwriting by banks was intended to avoid potential conflicts of interest. A bank could be tempted to bail out a shaky borrower by underwriting a public debt issue for that company --thereby shifting the risk to an unsuspecting public. But bankers argue that disclosure laws passed since the Depression make the Glass-Steagall prohibitions obsolete.

Financial Supermarkets

To a great extent, the banks are seeking to make money, through fees for financial services, without having to carry potentially risky loans in their portfolios. In many respects, this is a defensive response to the intrusion of other institutions and other companies into

activities that had always been considered central to the business of banking. Specifically, the emergence of the so called "financial supermarkets" can be seen as a real threat to the viability of the banking system. These "supermarkets" were designed to provide private both individual and corporate clients with a full range of financial services. Two trends were the prime contributors to the emergence of these highly diversified financial institutions. First, there were a large number of mergers in the financial industry involving firms in diverse businesses. Second, existing financial institutions developed innovative products to attract customers.

The largest of the mergers, of course, were well publicized. Prudential Insurance Company of America acquired Bache Group Inc., a leading securities dealer in April 1981. The company is now known as Prudential-Bache. American Express, one of the world's largest credit card concerns has acquired two brokerage firms, Shearson Loeb Rhodes and Lehman Bros. Kuhn Leob Inc. In recent years American Express had also bought another financial institution, Investors' Diversified Services. Sears, Roebuck and Company -the largest retailer in the United States- has bought a real-estate company, Coldwell Banker and Company, and the fifth largest brokerage firm in the U.S. By July 1982, Sears Roebuck and Company had opened financial services in eight stores to offer customers access to Allstate Insurance, and to the brokerage services of Dean Witter.

As in Canada, the last decade has seen the development of a vast array of innovative financial services in the United States. Perhaps the leader in innovation has been the nation's largest brokerage firm, Merrill Lynch Pierce Fenner and Smith. In 1977, it introduced the Merrill Lynch Cash Management Account (CMA), which itself has been an important stimulus to innovation by its competitors.

The Cash Management Account (CMA) offers integrated financial services by linking together a conventional securities margin account, three no-load funds invested in short-term securities, and a cheque/Visa card account maintained by Bank One of Columbus, services which usually are prohibited to a brokerage firm under U.S. Law. Bank One sets up special chequing accounts for CMA customers. When CMA customers issue cheques against their account, Merrill Lynch wires enough money into the account to cover the cheque. Account holders are also issued a Visa debit card for retail purchases. In spite of the fact that the CMA account requires an initial deposit of at least $20,000 in any combination of cash and securities, more than 900,000 people had put their holdings in Merrill Lynch CMA's by mid-1983.

Merrill Lynch has introduced a number of variations to the CMA. These include: a Cash Management Account Overseas Employee Program, designed to meet the financial needs of American citizens employed abroad; a CMA service for businesses, designed to meet both their working capital and investment needs; a Pension and Profit-Sharing Cash Management Account for plan trustees and administrators of small corporations (those with under $100 million in annual sales and with fewer than 500 plan participants); and a Uniform Gift for Minor Cash Management Account. These five variations of a central asset account within one company underscore how innovative firms in the financial industry are becoming.

The CMA account is tailored to high income investors. Other products are designed for individuals in middle income brackets. The money market mutual fund offered by a number of firms is essentially a demand deposit. The pooled contributions of investors are placed in a portfolio of money market securities, and the earnings, less a small management fee, are paid back to the depositors. In 1974, there were only 15 money market funds with $1.7 billion in assets. By the end of 1982, there were more than 180 funds with assets exceeding $200

million. Their popularity with the public can be attributed to money market funds being relatively riskless, liquid assets that are professionally managed and provide such features as cheque writing privileges. Perhaps most important in their growth is that, unlike bank deposits, there is no legal restriction on the maximum interest that can be paid to a depositor.

In 1972, mutual savings banks in Massachusetts introduced NOW accounts. NOW is an acronym for Negotiated Orders of Withdrawal. NOW accounts are chequing accounts which pay interest. Initially, Congress restricted these accounts to Massachusetts and New Hampshire. By 1976, all financial institutions in New England were permitted to offer NOW accounts. In March 1980, with Congressional passage of the Institutions Deregulation and Monetary Control Act, it became possible for NOW accounts to be offered nationwide.

In order to help banks and other financial institutions meet this new competition, Congress passed legislation in 1982 that expanded the range of services that they could offer, and provided for the removal of all interest rate ceilings by June 1, 1984. Two new accounts, the Super NOW Accounts and the Money Market Deposit Account, were authorized to allow banks and other deposit-taking institutions to compete directly with Money Market Funds. By law, these two accounts, each require an initial deposit of $2,500, are free of interest rate ceilings, are federally insured, and have specific chequing privileges. Only individuals, certain non-profit corporations and government units are allowed to own Super NOW Accounts, but there is no restriction on who can own a Money Market Deposit Account.

The two new accounts have proved to be very popular. Only two months after the legislative changes came into force, these accounts have brought $250 billion into deposit-taking institutions. These new accounts are seemingly popular with consumers because they are insured

and available from financial institutions close to their homes and places of business.

Aftermath of Deregulation

In general, the highly diversified financial institutions have not performed well. For instance, in the second quarter of 1984 Merrill Lynch lost $32 million in the second quarter. Sears Roebuck's earnings have continued to grow steadily, although its brokerage subsidiary, Dean Witter, lost $21.2 million in the first half of the year. More ominously, there have been a number of large collapses, and near failures of financial institutions. In 1980, Bache Group Inc., a large securities firm, and some of its lenders teetered on the brink of bankruptcy because of large loans to a wealthy family whose enourmous holdings in silver were plunging in value. In 1982, the collapse of Drysdale Government Securities Inc. forced the Chase Manhattan Bank to write off $135 million, and almost brought down a number of securities firms. In the same year, the failure of the Penn Square Bank of Oklahoma City would send shock waves through the financial industry, and eventually bring down Continental Illinois, the eighth largest bank in the United States. In 1983, two large insurance companies would file for bankruptcy.

Many reasons have been put forward for this poor record. One of the most common relates to the management of financial institutions being spread too thin, and the belief that executives skills gained outside of any type of financial institutions were not easily transferrable to such a company. Yet, each sector of the financial industry has had its own set of problems in recent years, and many of these are a direct consequence of deregulation.

On the lending side, institutions have been making loans with an increasingly high risk of default. In part, riskier loans have

been made because corporate borrowers -which traditionally have been the best customers of banks- are increasingly doing their financing through commercial paper issued by investment banks. For banks with more than $100 million in assets, the ratio of non-performing assets to total loans and real estate doubled between 1980 and 1983. This does not include most of the trouble loans to foreign governments, since American regulators generally allow banks to carry these loans on their books at 100 percent of their original value.

Risks have also been increased on the deposit-side of the balance sheet. Banks have increasingly funded their operations through large uninsured deposits from institutional investors around the world. Because of automation, large investors can move their funds from bank to bank almost instantaneously. At the first indication that a bank may be in financial difficulty, the large deposits are withdrawn, and a run on the bank begins. Consequently, as a result of all of the forces, by September 9th, there had been 55 bank failures in 1984, already surpassing the post-Depression record of 48 for an entire year.[10]

The precariousness of the American banking system is perhaps best illustrated by the crisis at Continental Illinois. The seeds of the bank's problems were sown with the collapse of the Penn Square Bank of Oklahoma City in 1982. In 1979 and 1980, years of energy shortages and soaring gasoline prices, Penn Square lent more than $2 billion to "wildcatters" and companies serving the oil-drilling industry in its home state, in spite of the fact, that the bank executives, like many of thier counterparts elsewhere thought that energy prices would continue to rise. The Illinois-based bank bought more than $1 billion of these loans. Two back-to-back recessions, plus a sharp decline in energy prices and rising interest rates pushed many of Penn Square's borrowers, and eventually the Oklahoma Bank itself, into default. There was a criminal element to the fiasco. In Oklahoma, a former executive of Penn Square has been charged with wire fraud and the misappropriation of bank

funds. At least one loan of $565,000, for instance, was made by Penn Square to a top executive at Continental. As well, there is evidence suggesting mismanagement. Internal reports at Continental indicating that Penn Square was in difficulty, were ignored, and, consequently, several of its executives were discharged for not maintaining adequate supervision over the Penn Square account.

When the Oklahoma Bank failed, the amount of its equity -or the sum of its collectable assets and funds put up by its shareholders- was not large enough to pay off all of the bank's depositors. Large depositors, whose investments were not insured by the Federal Deposit Insurance Corporation, lost their money.

The situation was different at Continental. The proportion of bad loans was not big enough to leave the bank insolvent. Yet, as Penn Square's plight was revealed to the public, Continental's depositors, especially the managers of large pools of money began to withdraw their deposits at a faster rate than the bank could replace them.

The first strategy that federal regulators employed to deal with the crisis at Continental was similar to ones used before in more or less identical situations. They tried to arrange a merger between Continental and another bank. But no willing merger partner could be found. Eventually, the Federal Deposit Insurance Corporation would insure all depositors, and the United States Government would effectively gain control of 80% of Continental's shareholders' equity. To pay for the bailout, the FDIC put up $4.5 billion from its own insurance fund; borrowed $3.6 billion from the Federal Reserve System; and, arranged a $5.5 billion line of credit with 28 private banks.

Thrift institutions have had special problems of their own along with sharing most of the difficulties of the banking industry.

The removal of interest rate ceilings has helped the savings and loan associations attract more deposits. But older low-yield mortgage make up a substantial proportion of many loan portfolios. High interest rates have helped thrifts to make more high yielding mortgage loans. But the number of homeowners incapable of paying the interest on their mortgages has also gone up, and the number of foreclosures has increased.

In 1982 alone, 1,100 thrifts disappeared either through mergers or re-organizations. Admittedly, that year of record high interest rates was one of acute crisis for the industry. But there has been little improvement since then. By some accounts, 40% of all thrifts have lost money in every quarter since 1982.[11]

Even the largest thrift in the country has not been immune from the crisis. Financial Corporation of America is a holding company with savings and loan subsidiaries. In the first half of 1984 alone it accumulated $10 billion from large depositors. These funds were invested in mortgages, on the presumption that interest rates would fall. That way, Financial could lower the rates that it paid to depositors, while its borrowers were locked in paying higher rates. But interest rates actually rose throughout the first half of 1984, and the thrift was actually forced to pay its depositors more than it was taking in interest income. In August, the Securities and Exchange Commission refused to accept certain accounting procedures used by the company. Financial was required to restate a previously reported 31 million second quarter profit as a $107.5 million loss. As in the Continental case, the money managers who held large deposits in Financial became nervous and began to withdraw their funds. In July alone, $114 billion in deposits was taken out of Financial. Part of the reason for their concern was that the Federal Home Loan Bank Board, the U.S. government agency which insures Financial, only had $6 billion in the insurance fund. The run on Financial was finally halted through a complex set of

government manoeuvres which leaves the large depositors insured, and, also in the Continental case, the institution effectively nationalized. Already, the government has used its influence on the board to get Financial's top executives, who also happen to be the funders of the company, dismissed.

The financial squeeze has also affected other sectors of the industry. After a decade of diversification and mergers, securities firms are finding that being large has its disadvantages on Wall Street. Merrill Lynch after expanding to about 44,000 employees, is now cutting back. But even retrenchment has its drawbacks in the securities industry. Customer loyalty is usually focused on the broker, and does not extend to the brokerage firm. Thus, if a broker is released by his employer , client will usually follow the employee to the broker's new place of work. Yet retrenchment has been found to be necessary, as margins become thinner. Fixed costs have risen rapidly in the industry in recent years, mainly because of the increased uses of computers in brokerage houses. At the same time, revenues for the large firms have shrunk as a Industry Association estimates that it takes a trading volume of 90 million shares a day on the New York Stock Exchange for the large securities firms to break even. In the second quarter of 1984, trading averaged 86.7 million shares a day.

As already mentioned, the liberalized regulatory environment in which financial institutions now function has served as a contributing factor to poor performance of some of the large firms. The resulting fierce competition has induced firms to adopt aggressive strategies that would not have been considered prudent in an earlier era. But beyond this, it is very difficult to establish any kind of causal relationship between deregulation and the financial problems that many firms are encountering. Clearly, for instance, financial services, like other sectors of the economy, have been hard hit by the volatile swings in both economic activity and interest rates. It is virtually impossible

to separate the effects of generally poor economic conditions from the consequences of deregulation in identifying the reasons why most of the problems occurred in the financial sector.

However, specifically when dealing with the banking industry, it is possible to conclude that allowing banks to diversify, primarily through relaxation of the Glass-Steagall separation between investment and commercial banking, did not play a great role in the difficulties experienced by some of the large institutions. It is noteworthy, for instance, that Continental's problems originated with its commercial banking operation, and not in any sideline that deregulation has opened up for the institution. Furthermore, it has been widely suggested that once the company got into trouble it might have been easier to arrange for a merger for Continental if some banning regulations were less restrictive. Continental may have not gotten into difficulty in the first place if it had been located in a state where banks were allowed to have more than one branch. This would probably have allowed Continental to diversify its asset base, thus making it more stable.

At other conglomerates, the management's unfamiliarity with financial services may have been cited as being responsible for financial problems at other firms. The executives at American Express were reportedly shocked by a large loss recorded at their Fireman's Fund insurance subsidiary. And, Dean Witter has proven to be a large drain on the earnings of Sears Roebuck. In one quarter alone, the brokerage subsidiary lost $22.7. As a result, while some non-financial firms are still trying to get into the industry, there is some evidence of movement the other way.

For instance, in 1981 Control Data began selling information and financial management services through its storefront Business Centres in 1981. The Business Centres lost $63 million in two years,

largely because management failed to perceive emerging competition from personal computers. By the end of 1984, Control Data expects to close between 100 and 120 of its Business Centres. For similar reasons, RCA Corp. sold its CIT Financial Corp. subsidiary to Manufacturers' Hanover in January 1984.

Canada

In Canada, as in the United States, the responsibility for regulating financial institutions is shared between the two senior levels of government. The Bank Act is the legislation which makes the federal government the prime regulator of the chartered banks. However, trust companies, loan companies and insurance companies all have the options of incorporating either federally or provincially. At the end of 1981, there were 32 federal trust companies with assets of $22 billion, and 67 provincially-incorporated companies with assets of $16 billion. Thirty-three loan companies had federal charters, while sixteen were incorporated in one of the provinces. The federal companies had assets of $20 billion while the provincial firms had assets of $5 billion. Statistics for insurance companies are not available.

To anyone familiar with the Canadian constitution this may be surprising. Section 91 of the British North America Act (BNA) gives the federal government exclusive jurisdiction over banking and the issuing of money. This would seem to leave little legal room for the provinces in the regulation of financial institutions. However, there is no definition of what constitutes a bank in the BNA Act or any other legislation. The issue had been sidestepped until 1980 by limiting the jurisdiction of the Bank Act to the specific institutions named in the legislation. In the latest revision of the Bank Act, provision was made for the incorporation of both foreign and domestically owned banks without the passage of a special act of Parliament. But there is nothing to

stop other institutions, whether incorporated federally or provincially, from providing all of the services that banks do.

Already, in the early 1960's, the Porter Commission appreciated that the assumptions that provided the rationale for the regulatory system were no longer valid. Separate rules for different types of financial institutions can only be justified if it is believed that each type of institutions has its own particular niche, and serves only a limited segment of the financial market. But the increased competition between different types of financial institutions was making this form of regulation obsolete. In addition, the Commission felt that this approach to regulation put limits on the type of business which may be conducted, the assets that may be acquired and the liabilities that may be issued by any type of institution. Thus, a particular pattern of specialization is formalized and the risk is run that institutions will be legally restrained from responding to new demands for financial services in a changing economic environment.

As an alternative approach, the Commission suggested that policy-makers recognize the spread of competition and seek to encourage it. It argued that a broader and less restrictive regulatory framework would permit each institution to do the sort of financial business it finds most profitable and would not stand in the way of evolving competitiveness. A flexible regulatory environment would not lead to uniformity among financial institutions. In other words, not everybody would become a financial supermarket, providing a full range of financial services. Some institutions would still capitalize on their individual expertise to offer a specialized service.

To accomplish this, the Commission recommended that the definition of banking be broadened to encompass all institutions issuing demand liabilities, transferable and short-term deposits, and other short-term banking claims. Federal regulation and supervision would

apply to all firms engaged in the business of banking. Provincially incorporated companies desiring banking powers would thus have two alternatives: to apply to the federal Parliament for a charter; or to apply to the federal government for a licence to operate as banks. The latter procedure was seen to be particularly applicable to provincially-incorporated money-lenders to which the Small Loans Act then applied. Some initial distinctions might have been made between federally and provincially incorporated institutions. But the Commission envisioned that this would be transitional, and, for the most part, both groups of institutions would be free to carry out the same range of business and be subject to the same regulations.

While the federal government did implement some of the recommendations of the Porter Commission, such as the removal of the six percent ceiling on loans, it did not extend its jurisdiction to all financial institutions. It did not even establish a uniform set of regulations for those institutions which are governed by federal law.

Yet, policy makers are publicly committed to nurturing competition in the financial sector. Many of the changes incorporated into the 1980 revision of the Bank Act reflect this. Procedures were adopted which would make the incorporation of new banks easier. No longer would an Act of Parliament be required, as banks could be incorporated by letters patent. In order to further increase competition, entry into banking was eased. For the first time provision was made for the incorporation of closely-held banks, in which one individual or group could have an interest of greater than of ten percent. This eliminated the necessity of a large number of investors being assembled before a new bank could be started. The new banks are given a time-limit to become widely-held. While they are still closely-held, they have the same legal status as foreign-owned Schedule "B" Banks. Each institution's capital has to be authorized by the Inspector General of Banks, and loans cannot total more than 20 times

that amount. Originally, foreign bank assets were restricted to eight percent of the total banking system, but in 1984, the ceiling was raised to sixteen percent.

Another measure designed to foster competition was the removal of the responsibilities for maintaining the cheque clearing system from the Canadian Bankers' Association, and their tranfer to a new body, the Canadian Payments' Association (CPA). This allows financial institutions, other than banks, to become directly involved in the daily clearing operations. Thus, other financial institutions have entry to a segment of the business that had been previously reserved for banks, and they have the option of participating in the evolution of policy for the system.

The chartered banks, by law, must be members of the CPA. All other financial institutions have the option of joining. But to become directly involved in the clearing operations, an institution must do one-half of one percent of the national clearing volume in terms of the number of items going through the system. Along with the banks, the other "direct clearers" are: Montreal City and District Savings Bank; Canada Trust; La Caisse Centrale Desjardins de Quebec; and, the Canadian Co-operative Credit Society. The Alberta Treasury Branches are scheduled to become direct clearers in late 1984.

Notwithstanding this recognition that competition was growing in the financial industry, and the attempts to foster more of it, different firms doing the same types of business are still governed by rules which allow for varying types of flexibility. This is most evident when the provisions of the Bank Act are compared with the federal legislation which governs trust and loan companies. In the Schedule "A" Banks, where there are no restrictions on growth, no shareholder can own more than ten percent of the outstanding shares. But there are no restrictions on how much of a trust or loan company any

one individual can own. While banks must hold primary cash reserves, the trust and loan companies have considerable choice in reserve instruments. This allows them to meet their legal reserve requirements by purchasing interest-bearing securities. Trust companies are not required to hold any reserves at all on term deposits maturing in more than 100 days, while banks are required to hold reserves against all deposits. The trust companies have a broad range of consumer and commercial lending subsidiaries engaged in types of activities that are defined as being ancilliary to the business of a trust or loan company; active in other countries or incorporated in one of the provinces; and temporary investments made to facilitate participation in a specific venture. By and large, the powers of the chartered banks are considerably less wide.

In 1982, the federal government made public proposed revisions of the Trust Companies Act and the Loan Companies Act. It was envisioned that the degree to which institutions participated in commercial lending would effectively distinguish trust and loan companies from banks. The chartered banks would continue to be unrestricted in their commercial lending activities. On the other hand, only fifteen percent of the assets of a trust and loan company could be devoted to commercial loans. This was not to include mortages against commercial property. To avoid conflicts of interest between commercial lending and trust activities, a company would be prohibited from investing trust funds in or lending trust funds to a corporation, if the trust company held a significant amount of the outstanding debt of the corporation. Such a prohibition would apply only where the trust company had discretion in how these funds were invested. Furthermore, a trust company might be forbidden from making commercial loans to a company whose shares or securities were listed on an exchange, since such shares are more likely to appear in trust portfolios than unlisted securities.

Financial Conglomerates

Whether this legislation is ever adopted, the trust industry can use its existing legal freedoms to bundle services, eventually, evolving into the kind of "financial supermarkets" that exist in the United States. Already, there is potential for such evolution in Canada. Through a holding company, trust firms can become part of a larger financial organization that sells everything from real estate to investment advice. The major shareholder of Canada Trustco Mortgage Co. is an insurance company, and Guaranty Trust is one arm of a financial conglomerate, the Traders' Group. Banks are at a distinct disadvantage, as they are barred from many such activities.

But it is the companies that are associated with Peter and Edgar Bronfman that are in the best position to evolve into "financial supermarkets". In particular, three of the companies that they control seem to be heading in that direction. They are: Hees International Corp., Great Lakes Group, Inc., and Trilon Financial Corp.

Hees, originally a company that made venetian blinds and window shades, is now quietly billing itself as a merchant banker along the lines of Lazard Frères and Rothschilds and Sons. Hees works with companies with poor loan prospects but good turnaround potential. It arranges financing for a troubled company at the same time that it helps in the restructuring of the firm, assists in the disposal or acquisition of assets, and provides other management expertise. In return, Hees takes an equity position in its client company. One of Hees' major holdings, North Canadian Oils, Inc., was acquired in this way. Hees holds positions of between 20 and 65 percent in firms that were formerly clients. Its other equity holdings are in companies like Trizec and Brascan which are also subsidiaries of Bronfmans' main holding company, Edper Investments Ltd.

Like Great Lakes, Hees handles private placements of securities, with the latter specializing the issues of preferred stock. Neither company is a registered investment dealer. Both have entered underwriting through a loophole in securities legislation. If a private placement is sold in lots of $97,000 or more, the deal does not have to be registered with regulators. (It is assumed that those putting in that much money are sophisticated enough to not need the protection of securities legislation. The preferred share offerings of Hees are bought in lots of a million dollars or more, well above the restrictions.)[14]

But it is Trilon that has advanced the most towards becoming an integrated financial institution. Its main holdings are the Bronfman's 50 percent interest in Royal Trust, and their 96 percent interest in London Life. Royal Trust, in turn, offers a full range of financial service as well as having a large real estate brokerage business. In October 1984, Royal Trust's real estate division merged with one of Canada's largest realtor, A.E. LePage. When the merger was announced, LePage's president, William A. Dimma, was very explicit about the potential for synergy. He told the press, "We can refer insurance business to London Life, and mortgage business to Royal Trust, and we would hope that they would refer real estate business to us."[15] Already, London Life agents have begun selling Royal Trust's registered home ownership savings plans, and mutual funds. The Bronfman's major partners in Trilon are the Toronto-Dominion Bank and the Jeffery family which owned London Life, before the company was taken over by the Bronfmans.

More than any entity in Canada, the Edper group of companies resemble the financial conglomerates in the United States. Taken together, these companies offer virtually every kind of financial service available. Trust companies, banks, and insurance companies are all involved in the conglomerate, either as operating units or as

partners in various ventures. At the same time, Edper has many non-financial interests. As in the United States, the management of the various companies did not wait for the regulatory "rules of the game" to change before launching new businesses. Rather, they attempted to utilize regulatory loopholes. Thus, in a very real sense, the industry is not being shaped by government policy, but, as in the United States, regulators seem to only be able to react to developments in the marketplace. Yet, the development of the industry cannot be left entirely to free markets. The co-mingling of so many financial and non-financial interests within a single corporate structure raises legitimate issues related to conflicts of interest and the protection of investors.

The Securities Industry

Change has occurred just as rapidly in the securities industry. Canada's brokerage houses, like other financial institutions, feel vulnerable to increased competition. The main function of these firms is the underwriting of corporate securities. However, investment executives estimate that large foreign dealers annually underwrite billions of dollars of new issues for Canadian corporations and governments wishing to raise capital in markets. Only one Canadian firm, Wood Gundy, is involved in the management of these large international issues.

Futhermore, an increasing number of new issues are being placed privately. This enables large issues to be handled by a single underwriter instead of being distributed through a syndicate, and the firms with the capabilities of marketing a whole issue often undercut their competitors in the fee for this service.

Thus, the market for underwriting securities in Canada is shrinking, and, the available business is being handled by an increasingly smaller number of firms. Because of their relatively small

share of the Canadian and international financial markets, the securities industry feels increasingly vulnerable in this new environment. While the largest investment house in the U.S. has more equity than the biggest bank in Canada, the combined capital of the entire securities industry is much smaller than the Toronto-Dominion Bank, the smallest of the so-called "Big Five" chartered banks, and none of the securities firms have an extensive nation-wide branch system like the banks. Brokerage firms have employed a variety of different strategies to increase their capital.[16]

At least three firms (First Marathon, Walwyn Stodgell Cochran Murray, and Midland Doherty) have made public share offerings. In 1982, the Ontario Securities held hearings into the implications of this. Widespread concern was expressed about maintaining the independence and professionalism in the industry if ownership of firms was unrestricted. The OSC recommended that no single investor in a securities dealer should own more than ten percent of the shares unless the investor is a director of the firm. And, not less than 40 percent of the directors of a securities firm had to be employed in the industry. Furthermore, all outside directors had to be approved by the responsible Self-Regulatory Organization and Securities Commission. The OSC was split on whether another kind of financial institution should be allowed to hold an interest in a brokerage firm. The majority felt that no ownership at all be allowed, while the minority would have permitted another financial institution to own up to ten percent of a securities firm.[17] The whole ownership issue is to be reconsidered in new hearings during November 1984.

Another way for a securities firm to raise additional capital is to merge with another firm. In Canada, there have been twelve such mergers in the last three years, including that between Dominion Securities Ames Ltd. and Pitfield McKay Ross Ltd. It is widely

felt that increasing competitive pressures will lead to more mergers in the industry.

Of course, a firm's equity can be increased by making it more profitable. To increase profitability, brokerage firms have also begun to offer a wider range of services. Increasingly, stock brokers are becoming involved in the selling of mutual funds and precious metals certificates. They are also increasing their business in real estate as well as financial and estate planning. Nesbitt Thomson Bongard Inc. has hired two financial consultants to work with high-salaried executives on a fee rather than a commission basis.

Also, securities dealers are placing stronger emphasis on their high rates paid on funds left in accounts that a company can use for general purposes. These have increased so rapidly that the banking industry has lodged complaints in briefs and presentations to various regulatory organizations. One dealer, Midland Doherty has introduced an account, which like Merrill Lynch's Cash Management Account in the United States, offers customers third party chequing services.

Green-Line Investment Service

Just as in the U.S., through such innovations, brokers are coming into direct competition with deposit-taking institutions. The Toronto-Dominion Bank has responded by introducing the Green Line Investor Service (GLIS), through which customers can place orders for trading stock through the bank's branches.

It was the removal of fixed commission rates that became effective on April 1, 1983 which made it possible for the bank to offer GLIS. When commission rates were controlled, prices were set at level which reflected the costs of providing a full brokerage business, which included the offering of such services as investment research and the

provision of financial advice. With the deregulation of rates, it became possible for new firms to undercut the large brokerage in the charge for executing trades of securities. The new "discount brokers" could maintain profitability because they provided none of the advisory services offered by the large houses. The emergence of the discount brokers closely parallels the American experience after the removal of fixed rates. The TD proposal entailed customer securities transactions being handled through a discount broker.

Before the GLIS was introduced, approval was needed from the OSC. The Commission held public hearings to consider the future implications of the bank's proposed new service.[18]

At the hearings, it became clear that the securities industry was vehemently opposed to the TD's initiative. Its representatives argued that the GLIS constituted encroachment into endeavors which have been traditionally regarded to be within the exclusive domain of the securities industry, and, eventually, given their size, the banks would come to dominate the securities industry. The "four pillars" concept would break down completely, and corporate power in the financial industry would be concentrated in the hands of the chartered banks. This, in turn, would generate conflicts of interest, and reduce the choices available to potential customers. For its part, the banking industry maintained that it was not contravening provision in the Bank Act and in provincial securities legislation which allowed it to engage in unsolicited trades for its customers.

In its report, the OSC noted that historically, the banks have always accommodated customers who wanted to trade equity securities indirectly through a bank rather than directly with a stock broker. Typically, the customer would advise the appropriate person in a bank branch of the intention to buy or sell specified securities. The branch would transmit the order to its regional office where arrangements would

be made for the execution of the order through a broker usually chosen by the bank. The trade confirmation would be forwarded to the bank, which would relay the information to the customer.

The OSC concluded that the Green Line Service was not merely an outgrowth of this. It noted that previously banks had not actively marketed their handling of securities. Apparently, this service was provided out of a sense of duty to customers in rural areas without convenient direct access to a broker. However, there is evidence to suggest that the primary beneficiaries are urban customers who are irregular traders and usually sellers.

In contrast, the OSC noted that the TD Bank designed GLIS to be aggressively marketed. It combined access to a discount broker with a number of other services such as: the provision of current market information; monthly updates on a customer's trading activity cash balances; safe-keeping and portfolio valuation reports. The bank also proposed to advertise GLIS through the mailing of brochures to its shareholders and customers as well as ads in the financial sections of newspapers. Because of this aggressive marketing campaign, the OSC did not allow the bank to offer GLIS under its "unsolicited service" exemption.[19]

Yet, the Commission did not accept the view that GLIS gave the bank access to activities that should be the exclusive domain of the brokerage business. The core function of the securities industry was defined as the underwriting of new issues. The OSC maintained that the operation of a full brokerage service was closely related to this core function, but that the relationship between a discount broker and underwriting was not as direct. Furthermore, fears about the banks' eventual domination of the securities industry were unwarranted. Many of the services provided by full-service brokers, such as the provision of research and investment advice cannot be legally performed by banks, and

to make them permissible would require the total abandonment of the "four pillar" concept by both the federal and provincial governments.

In line with these findings, the OSC recommended that the Securities Act be amended to allow for a new form of registration that would replace the unsolicited trader exemption. The new "broker access" category would be open to any institution providing access to a discount broker. There would be a number of conditions attached to registration which would ensure that there would be no encroachment on the core function of the securities industry. The registrant would be prohibited from entering into any arrangement, formal or informal, which would have the firm direct all or a substantial portion of its business all to one broker. Broker access registrants would be explicitly prohibited from providing advice on investments, and a statement to that effect would have to be carried on the client application form.[20]

Since the TD introduced GLIS, the degree of public acceptance has not been as high as originally anticipated. The bank's plans to extend the service from Ontario to the rest of Canada have been delayed, and none of the other banks has introduced a comparable service. Officials at the Toronto-Dominion say that they expect more business when the stock market pricks up. When that happens, executives at the Royal Bank say that that institution will enter this field.[21]

Quebec

The evolution of the regulation of financial institutions in the Province of Quebec has been markedly different from the rest of Canada. As such, it deserves special attention.

The philosophical underpinnings for legislation in Quebec is contained in the 1969 Report of the Study Committee of Financial Institutions. It argued that restrictions applying to borrowing and investing

were more severe for some type of financial institutions than for others. Fundamentally, such restrictions stemmed from the presumption that the public was best protected if financial institutions maintained their specialized role in the financial markets. The Committee challenged this by asserting that a portfolio's soundness could depend just as much on the diversification of its investments as on legally enforced specialization. Furthermore, it was argued that discrimination between institutions inevitably leads to discrimination between borrowers. (The development of the mortgage market illustrates this. The establishment by the banks of mortgage subsidiaries under the Loan Companies Act, described elsewhere in this paper, can be viewed as an avoidance of the discrimination against borrowers that is brought about by difference in reserve requirements between different types of financial institutions.)

This has a direct detrimental effect on economic efficiency and, in turn, led the committee to conclude that there should be few legal restrictions on how financial institutions should invest or borrow their funds.[23] Consequently, the report recommended that regulations for all types of financial institutions be contained in one piece of legislation. The act would be divided into three parts, one each for: borrowing and investing activities; insurance operations; and fiduciary activities. Every institution, upon its formation, would be granted the right to engage in all three forms of activity, and every firm regulated by this legislation would be automatically licensed for borrowing and investment. On the other hand, a business already engaged in borrowing and lending would need a special licence to engage in either fiduciary or insurance functions.

The committee wanted to leave financial institutions with as much flexibility as possible to pursue profitable activities. Thus, for businesses engaged in borrowing and lending activities (essentially, deposit-taking institutions), only four rules limiting the scope of

their activities were to be imposed. They would not be permitted to invest more than ten percent of their assets in any one enterprise. A maximum of seven percent of the firms assets could be invested in or loaned to what were considered to be risky companies. (These were defined as: firms that had not obtained a stated minimum yield on the book value of their shares over a fixed period; or, firms that failed to declare the dividends on preferred stock, or the principle due on its loans for a stated period.) A company's debt could not exceed 20 times its paid-up capital plus accumulated reserves. And, no absolute liquidity requirements would be imposed.

Of course, much of this reflects an approach similar to that of the Porter Commission whereby the activities of a financial institution would be shared more by market forces rather than by government regulation. Interestingly enough, the Quebec committee did not see any potential conflict of interest difficulties in allowing institutions to offer a full range of financial services. This too is in line with the Porter Commission which envisioned that all deposit-taking institutions would eventually be given fiduciary powers.

This laissez-faire philosophy is reflected in much of Quebec's new legislation. Bill 94 was adopted in December 1982. An agency, known as the Inspector General of Financial Institutions (IGFI), is established to be responsible for the protection of the public. But, the legislation also provides for a decentralization of control of intermediaries in the insurance field, effectively allowing the industry to police itself. The Quebec Government believes that public protection does not require that the Inspector General's office take the prime responsibility for protecting the public.

Re-enforcing this liberalization trend, in June 1983, the Quebec Securities Commission (QSC) voted against maintaining tight restrictions on who should be allowed to own a securities firm. Under

the ruling, anyone, including financial institutions can acquire control of an investment dealer, subject to the approval of the Commission. Securities firms should be free to acquire other financial institutions provided, again, that they have the approval of the OSC, and a separate subsidiary is set up for this operation. Financial institutions, may, through subsidiaries, register as investment dealers. The Commission has also ordered the Montreal Stock Exchange to repeal the provisions which restrict the ownership in an investment dealer to ten percent, and which prohibit brokerage firms from carrying out the functions of a bank, trust company, or insurance company.

La Fiducie du Quebec, the trust company of the Desjardins co-operative movement has applied for a brokerage permit from the Quebec Securities Commission. A restricted registration was granted. Clients are now able to phone the trust company and place or sell orders. Transactions must be executed through a broker that is a member of the Montreal Stock Exchange. Other companies that have received restricted registrations include National Trust and Royal Trust, a unit of Royal Trustco Ltd.

The Caisse Central Desjardins du Quebec, the wholesale branch of the co-operative movement, which issues deposit-like instruments, has made these instruments eligible investments for life insurance. The organization also takes a direct role in the National Clearing System.

But the philosophy of the Study Committee's Report is most clearly embodied in Quebec's Bill 75, which was enacted in June 1984. This legislation provides provincially-based insurance companies with the opportunity to engage in virtually any type of business. The Act gives insurance companies the right to provide some new services in-house. For some, approval of the Minister of Finance is needed,

while, to engage in some businesses, a separate subsidiary must be established.

Within its own organization, and without regulatory approval, an insurance company can, aside from its traditional functions, administer as a trustee its insurance and annuity premiums; administer as a trustee, the funds of tax deferred savings plans such as RRSP's and RHOSP's; provide financing for purchasers of insurance and annuity premiums; provide custodial and safekeeping premiums; offer custodial and safekeeping services; engage in leasing and real estate management; and market the products of other financial institutions.

What constitutes the product of other financial institutions has not been defined in the Act. But J.P. Bernier and Y. Millette, lawyers for the Canadian Life and Health Insurers Association, says that these include: insurance and annuity contracts issued by competitors; property and casualty insurance contracts; travellers cheques; credit or debit cards; savings plans; deposit instruments; equity type investment products; loans; government securities where distributed through authorized financial agents; corporate securities where the purchase is arranged through investment dealers, underwriting syndicates, or discount brokers; any financial products identified by trade marks; and any new financial products developed by a financial institution abroad.

According to the same legal opinion, the approval of the minister is required for such activities as: deposit taking; the underwriting of government and corporate securities; real estate brokerages; foreign exchange; acting as transfer agent and registrar; and full fledged fiduciary and trustee services. When insurance companies want to engage in activities that are outside of the financial industry, a special subsidiary must be established. No regulatory approval is required, and investments in subsidiaries are subject to ceilings expressed in percentages of the insurance company's assets.

Clearly, the enactment of Bill 75 erodes the "four pillar" system of regulation. In a brief commenting on the legislation, the Canadian Bankers' Association notes the erosion of the traditional separation between the real and financial sectors of the economy. The CBA thinks that the legislation has a number of other shortcomings. It mentions the inherent conflict of interest problem between lending and other financial activities which has already been mentioned in this paper. They argue that Bill 75 relaxes the prudential investment standards. Unsecured commercial lending is characterized as a high-risk venture for firms that allegedly would have little expertise in this area. The CBA is also critical of the lack of any restriction of any individual owning more than ten percent of an insurance company. Closely-held insurers are deemed to be susceptible to self-interest manipulation by controlling shareholders in a manner contrary to the best interest of the corporation's depositors, policy holders and minority shareholders. It also contends that Bill 75 represents a departure from the loose pattern of federal-provincial co-operation in setting major financial sector rules and prudential controls which has traditionally prevailed.

If insurance companies move into areas that have been traditionally within the domain of other financial institutions, the banks threaten to seek ways of doing the same. Other institutions can be expected to follow suit.[23]

DEPOSIT INSURANCE

It is almost universally recognized in North America that the small investors who entrust their savings to financial institutions should be insured against the financial collapse of that institution, because most members of the general public are unable to assess the risk of individual financial institutions. This is the rationale behind legally requiring financial institutions to contribute premiums to a fund that reimburses small depositors, in cases where financial institutions are not able to meet their financial obligations to them.

Yet, in spite of what seems to be the eminent wisdom of having deposit insurance, the United States has had federally insured deposits for much longer than Canada. Deposit insurance was instituted as part of the Glass-Steagall reforms that were enacted after the large number of bank failures during the Depression. Canada did not get federal deposit insurance until 1967. In the United States, all deposits up to $100,000 are insured. From 1967 to 1982, deposits were insured in Canada only up to $20,000. Then, in 1982 the limit on insured deposits was raised to $60,000.

This does not mean that the American system does not have its flaws. While the law decrees that deposits only up to $100,000 are insured, effectively, all deposits are protected. When a deposit-taking institution fails, federal authorities attempt to arrange a merger with a more healthy institution. If the Federal Deposit Insurance Corporation can do this successfully, not even the large depositors lose any money. The knowledge that a merger will probably be arranged, and no money will be lost reduces any incentive that large depositors may have to withdraw their deposits from an institution that is following an irresponsibly aggressive business strategy. Re-enforcing this reluctance is the tendency for the banks with the most aggresive lending policies to be the ones thay pay the highest return on deposits. Thus,

some observers feel that there is actually an incentive for money managers to invest funds in the more risky banks. This only encourages the management of these banks to pursue even more irresponsible practices. Critics of the present system argue that, if large depositors felt that they were more likely to lose money in a bank failure, they would withdraw deposits from banks that were thought to be managed in an unsound way. In turn, the knowledge that large depositors might withdraw their money would encourage the banks to behave more prudently.

Under the present system, the largest depositors in the big banks in the United States are other banks. Thus, the failure of any large bank in the United States could produce a chain reaction which would see the collapse of other smaller banks. Thus, effectively the risk of bank operations is passed from the private sector to a federal agency, in most cases the FDIC, which must pay off all insured depositors.

The chairman of the FDIC, William M. Issac has suggested two reforms to deal with this. One would force banks to pay risk-adjusted premiums. With all deposit-taking institutions paying the same premium rate, the sound institutions effectively subsidize the shaky ones. The problem with a risk-adjusted premium is finding an objective measure of risk.[24]

The same problem can be said to exist in Canada. The risk of one of the major national bank failing is obviously not as great as the chances of a smaller financial institution going bankrupt. There has not been a bank failure in Canada since the 1920's. In marked contrast, in just the last few years, a number of credit unions and trust companies have collapsed. The stability of the Canadian banks is probably attributable to their nation-wide branching network which gives them highly diversified deposit bases and loan portfolios. Yet, all

institutions insured by the Canada Deposit Insurance Corporation pay the same premium rate.

The other reform that Issac wants to see would set new rules for handling large deposits in a bank failure. Depositors with more than $100,000 in a failed institution would still incurr some loss, even if that institution were successfully merged with another one. Again, this would be done to encourage money managers to shy away from risky banks. With $400 billion deposited in accounts of $100,000 or more, the impact on the banking system could be significant.

It should be again remembered that despite Issac's rough language the agency that he heads did rescue Continental Illinois, at considerable expense to the American taxpayer. The rationale for this bailout of the large depositors, even in the light of the FDIC's failure to find a merger partner, was that a Continental failure would have led to the collapse of many of 2,000 small banks that held more than $3 billion at Continental. At Congressional hearings, Issac's estimate of the number of banks that Continental would have brought down with it has been challenged as being too high. Nevertheless, large depositors can only be made to feel more secure by the Continental precedent, and the changes for introducing more discipline into the American financial system have been reduced.

In 1967, in reaction to a number of well-publicized bankruptcies, the Canadian government as well as the provinces of Quebec and Ontario enacted deposit insurance legislation. The Ontario legislation was enacted five days before its federal counterpart.

All chartered banks and federally-incorporated trust companies must be members of the CDIC. Provincially-incorporated trust companies have the option of joining CDIC under the condition that they agree not to exercise powers that are substantially different from those

exercised by federally-incorporated companies. The CDIC has 137 members, 65 of which are provincially-incorporated.

The Ontario act was similar to the federal one. After the CDIC went into business, the Ontario plan was suspended and all of the Ontario companies concerned were subsequently accepted as members of the CDIC on April 29, 1967. The Quebec plan would not only insure deposits within the province, but also deposits with institutions incorporated in Quebec but placed outside of the province. To avoid duplication, the CDIC and the QDIB concluded an agreement which called for: the CDIC insuring deposits accepted outside of Quebec by these institutions incorporated in that province; the QDIB would insure all deposits placed in Quebec in any institution incorporated in Quebec or in any other province, including those deposits that had formerly been insured by the CDIC; the CDIC would insure the deposits of federally-incorporated institutions in Quebec and would make short-term loans to the QDIB which would help it meet short-term liquidity needs.

Under the provisions of the Investment Companies Act, the CDIC is empowered to make short-term loans, as a lender of last resort, to Canadian-controlled sales finance companies. Also, under the provisions of the Co-operative Credit Association Act, the CDIC is empowered to make short-term loans for liquidity purposes to co-operative credit societies, and to provincially created corporations that provide, or administer stabilization or liquidity funds for the benefit of credit unions and their members. This is entirely separate from the CDIC's primary function. The CDIC does not insure the debt of sales finance companies or the deposit and debt instruments of credit unions. The loans may be made only for the purposes of meeting short-term requirements for liquid funds and the CDIC gets the money to make these loans from the federal government's Consolidated Revenue Fund. The CDIC has entered into agreements to make such loans with credit union stabilization boards in British Columbia, Alberta, and

Saskatchewan. Up until now, no loans have been made under the terms of either act.

In the furtherance of its primary function of insuring deposits, among other powers, the CDIC may also make or guarantee loans to or deposits with its member institutions for the purpose of averting or reducing a threatened loss.

The CDIC is funded by its member institutions by premiums which are assessed on the insured deposits as at April 30th of each year. An institution's premium can be as high as one-thirtieth of one percent of its total deposits. Also, the Minister of Finance is authorized to make loans of up to $1.5 billion to the CDIC from the Consolidated Revenue Fund.

Since its inception, the CDIC has had to make advances to 13 member institutions. All but two have been made since 1980. The CDIC has not recovered funds from any of the advances that it has made since 1982. Most of its 1983 advances were associated with the Greymac affair in Ontario. As a result, the CDIC's fund has gone from a surplus position of $250 million to a deficit of $332 million in just one year.[25]

A number of solutions have been proposed for eliminating the CDIC's deficit. One is to raise premiums. The chartered banks oppose this because a rise in premiums would only increase the degree to which they subsidize institutions with more risk. Another solution would see the CDIC become a subsidiary of the Bank of Canada and the interest from the central bank's reserves be applied to the CDIC's deficit.[26]

CONCLUDING REMARKS

The clearest lesson from the experience of the last two decades is that the influence that government regulators have over the structure of financial markets is limited. Competitive forces are more of a determinant.

At the beginning of the period covered by this study, the financial industries in both Canada and the United States were heavily regulated. Each country prohibited institutions from carrying out both investment and consumer banking. Similar restrictions did not exist in most other industrial countries.

Apart from this, governments in both countries attempted to curb excessive concentrations of economic power in the financial industry. In the United States, institutions were not allowed to engage in banking in more than one state. And, as a result, the American banking system evolved into a very diffuse one, with more than 14,000 separate institutions. In marked contrast, Canada did not impede the development of institutions that did business across the entire country. Consequently, the "Big Five" chartered banks have always assumed a position of dominance in the capital markets. Yet, the restrictions against one party owning more than 10% of a chartered bank can be seen in part as arising out of the same concerns about the concentration of economic power. And, the legal restrictions which places limits on the ownership by banks and other institutions of businesses outside of the financial industry, effectively is a check, albeit a small one, on this economic power being diffused through the rest of the economy.

In both countries, economic pressures provided the main impetus for the removal of many of these restrictions. Policy makers in the United States, as an example, never made an explicit decision to remove the restriction on inter-state banking or repeal the Glass-

Steagall prohibitions against individual institutions doing both commercial and investment banking. Yet these walls have largely crumbled, because of individual corporate decisions. Innovation in the provision of services has been key to this process. For instance, Merrill Lynch's introduction of the CMA account brought the brokerage industry into direct competition with banking. And, it was the collapse of much of the thrift industry, brought about by economic circumstances that really had nothing to do with regulatory changes, which virtually forced authorities to allow for mergers with out of state financial institutions. Similarly, no specific regulatory change served as the catalyst for the emergence of the so-called "financial supermarkets". Rather, companies like American Express and Sears Roebuck took advantages of grey areas of law to acquire companies offering a wide range of financial services.

Much the same has happened in Canada. In the 1967 Bank Act revision, the six percent ceiling on interest that the banks were allowed to charge on loans was removed. As in the United States, this "deregulation" was brought about by economic necessity. In general, the pace of "deregulation" proceeded at a slower pace in Canada. There were no significant changes to trust and loan legislation; and, by not adopting the principle recommendations of the Porter Commission, and thereby having each type of financial institution maintain its own distinctiveness, policy makers clearly demonstrated their preference for maintenance of the four pillars. But, competition increased steadily between different types of financial institutions making the existing legal framework both obsolete and discriminatory. And even as regulators keep declaring their support for the "four pillars" concept, the distinction between the pillars is continually being eroded. Much of the erosion -- such as the payment of interest on funds held in accounts by investment dealers; and the emergence of multi-functional firms such as Trilon -- has been discussed in this paper. As in the United States, the main role of regulators has not been to direct the

future shape of financial market, but to bring laws into line with an ever changing economic environment.

Another important trend has been a shift in the purpose of regulation from protecting the small unsophisticated investor to protecting the public purse. Originally, the protection of investors' funds was the prime objective of regulators. But with the advent of deposit insurance, only large depositors and investors stand to suffer a financial loss. Now, the deposit insurance fund absorbs the financial loss from all such failure. This raises a number of important policy questions. Most fundamentally, should depositors be freed from all risk? Or, does the presence of the possibility that depositors may lose some of their investment impose a discipline on the managers of financial institutions which leads them to manage the funds entrusted to them in a more responsible way? With investors largely protected, regulators might be able to afford to exercise much looser control over financial institutions, even to the point where some institutions are allowed to fail. These are some of the important questions that policy makers will have to deal with in the coming years.

NOTES

1. E.P. Neufeld, The Financial System in Canada: Its Growth and Development, (Macmillan: 1972).

2. Ibid., p. 57.

3. Report of the Royal Commission on Banking and Finance (Queen's Printer: 1964), p. 108.

4. For a discussion of this topic in depth, see H.H. Binhammer and Jane Williams, Deposit-Taking Institutions: Innovation and the Process of Change, (Economic Council of Canada: 1976).

5. Ibid., pp. 18-25.

6. Ibid. p. 4.

7. Richard Skinulis, "A Free-For-All in ATMs? New Network May Battle the Banks, in Financial Times of Canada, September 4, 1984, p. 13.

8. Martin Mittelstaedt, "Trust Firms Lose Mortgage Business to Chartered Banks", in The Globe and Mail, September 4, 1984.

9. "Banker as Broker", in Business Week, April 11, 1983, pp. 70-74.

10. Lester Thurow, "America's Banks in Crisis", in New York Times Magazine, September 16, 1984.

11. Tim Carrington and Daniel Hertzberg, "Money at Risk: Financial Institutions are Showing the Strain of a Decade of Turmoil", in The Wall Street Journal, September 5, 1984, p. 1.

12. The description of the crises at Continental Illinois and Financial Corp. is largely based on the Thurow article cited above.

13. Tessa Willmont, "Hees Making Name as Top Merchant Banker", in The Financial Post, October 13, 1984, p. 1.

14. Dianne Malley, "LePage, Royal Trustco Unit Merge Real Estate Operations", in The Globe and Mail, October 22, 1984, p. B1.

15. Bernard Simon, "Canada's Securities Houses Bow Before Winds of Change", in Financial Times (London), May 10, 1984, p. 24.

16. See Ontario Securities Commission, Report To The Minister of Consumer and Commercial Relations Regarding: Institutional Ownership of Securities Dealers Registered Under the Securities Act and Diversification Into Other Businesses by Securities Dealers Registered Under the Securities Act, December, 1982.

58. J. Pate, "Statistics on the Federal Response to Criminal Conduct by Bank Officers, Directors and Insiders: A. Staff Analysis", Subcommittee on Commerce, Consumer and Monetary Affairs, May 2, 1984.

59. Peterson and Scott, *supra*, note 32 at p.4.

60. Bovenzi and Nejezchleb, *supra*, note 29 at p.58.

61. *Ibid.*

62. *Ibid.*, pp.59-62.

63. "The Demise of the Bank/Non-Bank Distinction: An Argument for Deregulating the Activities of Bank Holding Companies," 98 *Harvard L. Rev.* 650 (1985).

64. Short et al., *supra*, note 36 at p.7.

65. Peterson and Scott, *supra*, note 32 at p.3.

66. Barth et al., *supra*, note 30 at p.16.

67. Benston, *supra*, note 37 at p.13.

68. Peterson and Scott, *supra*, note 32 at p.6.

69. *Ibid.*, pp.2-3.

70. *Ibid.*, p.7.

71. *Ibid*.

72. *Ibid*., pp.7-8.

73. Bovenzi and Nejezchleb, *supra*, note 29 at pp.64-65.

74. *Ibid.*, pp.66-67.

75. *Ibid.*, p.67.

LIABILITIES: Although (i) the absolute size of "accounts payable to clients, brokers and dealers" is less than its asset counterpart, and (ii) the account fell-rose (30.5/24.8/29.4% over '78/79/84), it did mirror its cousin in being the largest category.

Otherwise over '77-84 and in terms of large dollar movements, there were net falls in (a) chartered bank call loans (29/10/13% over '79/83/84), plus (b) loans under buy-back arrangements (11/3/7% over '77/82/84). And contrarily there was a considerable expansion of clients' free credit balances (2.6-13.3%).

(The balance of the shrinkage in the former two loan categories was absorbed by growth in: (1) Subordinated loans from (i) banks (.39/.82/.58 over '77/81/84), (ii) shareholders (0.4-1.1%), and (iii) others (.24-.48% over '77-81). (2) 'Accounts payable other than to clients, brokers, dealers or else clients' free credit balances' (1.2/2.7/2.2% over '77/83/84). (3) Liabilities to parents and affiliates, (0.1-0.3/1.7/0.3% over '77-81/82/84. (4) "Other liabilities" (.06-.37%) (5) Retained earnings (very roughly 2/4% for '77-79/80-84).

Finally, it's notable that while the total size of share capital remained fairly constant over '77-84, there was a change in the relative mix, with common shares expanding, and with preferred shares declining.

REVENUES: There are suggestions here that the recession considerably altered the ways that Dealers make their money in that (a) the highest values for "underwriting and trading profits" occurred in '82-84, and (b) the lowest values for "brokerage commissions" occurred in '81-84. Furthermore, it would appear that Dealers efforts toward asset diversification have begun to bear fruit as "other revenue" rose 1.6-4.3% over '81-84.

EXPENSES: These accounts were quite stable, although the categories are obviously broad.